

**DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 97-0090
Sales and Use Tax
For The Tax Periods: 1994 through 1996**

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ISSUES

I. Sales/Use Tax – Lab Supplies

Authority: 45 IAC 2.2-5-8, 45 IAC 2.2-5-10, *Indiana Department of Revenue v. Cave Stone*, 457 N.E.2d 520 (Ind. 1983).

The Taxpayer protests the imposition of sales/use tax on equipment used to create the desired colorant for the customer.

II. Sales/Use Tax – Cleaning Solutions

Authority: IC 6-2.5-5-5.1, *Kimball International v. Indiana Department of Revenue*, 520 N.E.2d 454 (Ind. App. 1988), *General Motors Corporation v. Indiana Department of Revenue*, 578 N.E.2d 399 (1991).

The Taxpayer protests the assessment on cleaning solutions used to purge the manufacturing equipment.

STATEMENT OF FACTS

The Taxpayer combines various colorants, stabilizers and carriers to produce specific colors for their customers, which consists primarily of the plastics industry. The Taxpayer's customers submit samples of their products along with the desired color to the Taxpayer. The Taxpayer

then mixes different paint beads in order to create a matching formula which may be used in the customer's proprietary manufacturing process. To do this, the Taxpayer must mimic the customer's production process to produce the product sample. Upon approval by the customer, the Taxpayer continues production of the colorant beads or granules in industrial quantities. More facts will be supplied as necessary

I. **Sales/Use Tax – Lab Supplies**

DISCUSSION

Pursuant to 45 IAC 2.2-5-8(c):

The state gross retail tax does not apply to purchases of manufacturing machinery, tools, and equipment to be directly used by the purchaser in the production process provided that such machinery, tools, and equipment are directly used in the production process; i.e., they have an immediate effect on the article being produced. Property has an immediate effect on the article being produced if it is an essential and integral part of an integrated process which produces tangible personal property.

During the audit, the Taxpayer was assessed sales/use tax on equipment used to create colorant formulas on the basis that it was used for research and development. The process in question begins with the customer providing the Taxpayer with a sample of the color requested and a sample of the item to be colored. The Taxpayer then uses a portion of the colorant bead or granules to produce a sample of the customer's product and in the process must mirror the customer's production process in order to insure that bead composition is compatible with the customer's production operation and materials. The Taxpayer forwards the colorant beads or granules and the finished product sample to the customer for approval of the colorant. The customer tests the formula in their production process. If the formula meets the customer's standards, the Taxpayer continues the production of the colorant bead or granules, if not, the Taxpayer adjusts the formula until the desired colorant is created.

The Taxpayer argues that this equipment is used within the integrated production process of the colorant. "Direct use in the production process' begins at the point of the first operation or activity constituting part of the integrated production process and ends at the point that the production has altered the item to its completed form, including packaging, if required." 45 IAC 2.2-5-8(5)(d). The Taxpayer states that the production process begins with the production of the colorant, and the first segment of the manufacturing process begins with the manufacturing of a color formula. They also contend that the process does not qualify for a federal credit for research and development. The Taxpayer states that this credit is available to those who perform research and development for the enhancement or creation of their own products. They are not developing a new product to sell, but rather, producing the necessary molecular configuration for a colorant that can be used in the customer's production process.

Also, the Taxpayer argues that Regulation 45 IAC 2.2-5-10 indirectly illustrates that research and development of new products of the taxpayer lacks the essential and integral relationship with the integrated process, Regulation 45 IAC 2.2-5-10(3) states:

Because of the lack of an essential and integral relationship with the integrated production process in Example (1), the following types of equipment are not exempt.

...

(B) Equipment used for research and development of new products.

Assuming that the Taxpayer could not qualify for the federal credit for research and development, they must still demonstrate that this process is considered part of the production process. To be considered part of production process, the process must be considered “essential and integral” to the completion of the product. *Indiana Department of Revenue v. Cave Stone*, 457 N.E.2d 520 (Ind. 1983). The Court recognized that the whole production process must be analyzed to determine whether the equipment used in production had an immediate effect on the completed tangible personal property.

The Taxpayer states that the first step in producing the product to be sold is formulating a colorant that can be used in its individual customer’s production processes. Thus, they may not continue production unless the colorant meets the customer’s requirements and that creating the colorant is essential and integral to providing the finished product, which is the colorant requested by the customer. Since the Taxpayer is not developing a new product to sell, but rather, producing the necessary molecular configuration for a colorant that can be used in the customer’s production process, they are merely providing the correct color for production. Once the Taxpayer matches the colorant to the customer’s request, they use the same process as used in the past to mass produce it. Thus, the Taxpayer is merely matching the color prior to production. It is analogous to artwork that has been created prior to being printed. The Taxpayer is not producing the formula, but rather, making preparations to produce it. Therefore, the process is not essential or integral to the production process.

The Taxpayer argues, in the alternative, that creating of the correct formula for their customers and the production runs may be considered two distinct production processes. The creation of the formulas is the consideration for the mass production runs. They contend that they are producing the formula in order to sell the product in mass quantities and that the formula produced is a marketable item. However, the sample is not sold to the customer and is not consideration because the customer is not obligated to purchase the colorant if they are not satisfied.

FINDING

The Taxpayer’s protest is respectfully denied.

II. Sales/Use Tax – Cleaning Solutions

DISCUSSION

The Taxpayer protests the assessment of sales/use tax on the cleaning solutions consumed while purging the manufacturing equipment to remove colorant residue left in the equipment from the previous production run. The Taxpayer contends that the cleaning is very important to the production process and should be considered an essential and integral part of their production process.

Pursuant to Regulation 45 IAC 2.2-5-12 (e):

Purchases of materials to be consumed during the production or mining process are exempt from tax, if the consumption of such materials has an immediate effect upon the article being produced or mined or upon machinery, tools, or equipment which are both used in the direct production or mining process and are exempt from tax under these regulations.

The Taxpayer states that it is imperative that any residual colorant on the manufacturing equipment be cleared before a new colorant is produced because the residual colorant would compromise the integrity of the next colorant produced. In order to produce items the Taxpayer's customers have ordered, it is essential that the manufacturing equipment be free of any contaminating agents.

However, the cleaning is not conducted "during the production" but rather in between production runs. Pursuant to Regulation 45 IAC 2.2-5-12:

- (d) Pre-production and post-production activities.
 - (1) Direct consumption in the production process begins at the point of the first operation or activity constituting part of the integrated production process and ends at the point that the production process has altered the item to its completed form, including packaging, if required.

Here, the cleaning solutions are used to purge the equipment after the product has been altered to its completed form, *i.e.* the colorant. Additionally, the cleaning of the equipment takes place prior to the next production run.

The Taxpayer also contends that the purging is "essential and integral" to the production process and the solutions are closely connected with the production of the goods. The Taxpayer compares the situation here with *Kimball International v. Indiana Department of Revenue*, 520 N.E.2d 454 (Ind. Ct. App. 1988). In *Kimball*, the Indiana Court of Appeals granted an exemption for spray booth coating and paint deflocculent. The coating is basically a removable paint applied to the walls of the spray booths for the collection of excess spray. The deflocculent is a chemical added to the water baths, which are used to remove the excess spray and holds the excess spray in suspension and promotes its removal from the finishing room.

Yet, the chemicals used to promote the removal of the excess paint in *Kimball* are used during the production process. Here, the cleaning solutions are used to prepare the equipment for the next production run. At the time the manufacturing equipment is being purged, no production is taking place. The cleaning solutions are used to prepare the equipment prior to the production of the colorants.

The Taxpayer also argues that in creating these exemptions, the intent of the legislature was to encourage industrial growth by allowing an exemption for items closely connected with the production of goods. Additionally, the Taxpayer states the goal of manufacturing exemptions is to prevent tax pyramiding.

All sales tax laws exempt or exclude some retail sales. The reasons for this treatment vary. Goods used in the manufacturing process are exempt entirely or partially by all state laws to avoid tax pyramiding, that is. The situation where a tax is levied on a tax and the result is a retail price increase greater than the amount of the tax.

General Motors, N.E.2d at 405 (quoting *Welsh v. Sells*, 192 N.E.2d 753 (1963)).

The Taxpayer states that if the cleaning solutions are taxable, they will likely pass the cost along to its customers, who, in turn, will pass it on to their customers. However, the Taxpayer has not shown that the cleaning solutions are used during production process. Thus, the arguments for broad interpretation of the exemptions are not helpful to the Taxpayer's cause.

FINDING

The Taxpayer's protest is respectfully denied